



HISTORICAL PERSPECTIVE ON BEAR MARKETS AND OUR
CURRENT MARKET OUTLOOK

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A Review of Past Bear Markets

Broad stock market declines are very disturbing. They come about as a result of stock prices climbing too high (greed) in combination with developing economic problems, and are usually exacerbated by human emotion (fear). Stock prices experienced a solid five year run from 2003-2007 in virtually all stock markets around the globe with the S&P 500 returning 82% during the period. In 2008, the world-wide banking crisis has ushered in a recession, which very well may be pronounced, in terms of depth and length. If so, this will rival the 1973-1974 recession as the worst since The Great Depression. The stock market declines over the past 13 months have already approximated the 1973-1974 declines of 50%.

As another point of comparison, 2008 is on track to be the single worst year ever for the stock market and is often compared to the period from 1929-1932 when the market declined 88%. It should be noted that in the 1929-1932 depression, unemployment reached 25% and GDP declined by 15%; we would expect worst case scenarios for the 2008-2009 recession of unemployment of 10% and a GDP decline of no more than 5%.

The actions taken by the Federal Reserve in 2008 stand in sharp contrast to policymaker actions during the depression. In the 1929-1932 depression the Fed raised the discount rate on several occasions, failed to address a shrinking money supply and stood by passively as countless banks failed. To deal with the current crisis the Fed has aggressively cut rates, facilitated significant growth in the money supply and pulled out all the stops in its efforts to support banks and other financial institutions.

In late 1999, Warren Buffett wrote a piece for Fortune magazine, in which he said that the next 17 years would be in sharp contrast to the previous 17 years from 1982-1999, primarily due to the high price level of the stock market. He suggested that these long periods are not unusual, mentioning 1966-1982 as a similar long period of below average returns. Last month Mr. Buffett wrote an op-ed piece for the New York Times, saying he was buying U.S. stocks now, relating the dictum that one should buy when people are fearful (and therefore prices are low), and sell when people are greedy (prices are high).

Current Valuations

We agree with Mr. Buffett and we too have become much more positive on stocks, knowing that while the economy will get worse as we enter 2009 and may not notably improve for a year or more, the stock market will reach a bottom well in advance of such a recovery. Perhaps the best valuation support is that the current dividend yield on the S&P 500 is now greater than the yield on the US Treasury 10-year note for the first time in 50 years! If the S&P 500 only returned to its April 2000 level in the year 2016, that appreciation, coupled with the dividend yield, would result in an annualized total return of over 12%. Given today's very low money market rates of 2%, this suggests that stock investors would be nicely rewarded under that scenario.

Other asset classes such as non-US equities, as well as many fixed income securities, have similarly attractive return prospects, as the current need for liquidity by some market participants seems acute. Corporate bonds, in particular, are at record low valuations compared to other asset classes. Stocks should benefit from lower corporate bond yields as debt markets recover. Someday this bear market will end, but that may not be until sometime next year: the timing of such is unpredictable. Yet as long-term investors we will continue to search for attractive investments. The biggest challenge will be our fundamental estimates of income statements, balance sheets, and cash flow statements. History may be of limited use in those efforts.

At the bottom in August of 1982, my model forecast a 5-year annual return of 20%, driven largely by a forecast of lower interest rates and higher valuations, and returns ended up reasonably close to the forecast. A recent Merrill Lynch survey of fund managers said that 80% are forecasting a world-wide recession to continue through all of next year. I think that is a reasonable forecast, but more importantly this suggests that stocks are discounting such an outlook already. A Federal Reserve Governor was quoted as saying the Fed would make sure deflation would not occur. [An eventual return of problematic inflation seems a more likely risk, given the immense injection of liquidity currently ongoing.]

How we think about individual sectors and stocks

In this environment in particular, I believe it is helpful to remember Buffett's dictum that when a good management meets a bad industry, it is the latter whose reputation remains intact. We are concerned that areas of overcapacity like banking and retailing may be such industries. Part of the overcapacity is a function of the Internet Revolution, analogous to the Industrial Revolution during the 1800s. In contrast, we remain very positive on our commodity related holdings. While there is little doubt that commodity demand has been reduced due to both the very high prices earlier in the year and now the recessionary cycle, demand growth from emerging economies (such as China, India, and many others) coupled with supply constraints puts long-term upward pressure on prices, and thus the secular case is intact. While expectations vary by sector, we are of the belief that from current prices the market could reasonably generate a total annual return of 12% for the S&P 500 over the next five years.

In seeking out individual companies for investment we believe that, generally, good businesses with strong balance sheets (no need for financing) should generate returns that exceed the returns of the market and of companies subject to dilution. Fortunately, we have consistently said that we are benchmark agnostic and so owning "growth" stocks is not problematic, and having little or no representation in the stocks which we believe will lag has helped us in the past and should help us continue to:

1. Achieve satisfactory returns on an absolute basis,
2. Add value above passive alternatives, and
3. Rank highly among our peers.

Long Term Temperament

As you know one of the cornerstones of our investment philosophy is to have and maintain a long-term temperament. It is difficult in any human endeavor to remain patient and think long-term when current events are so troubling; however, it is precisely times like these when we must think and act with a long-term perspective in mind.

We, at Diamond Hill, strongly encourage all of our staff to invest in the same portfolios that our clients are invested in and, as a result, we are collectively the largest shareholders in the Diamond Hill Funds. I want to thank all of our clients as well as their advisors for investing with us and for your patience in these difficult times.



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